



EUROPEAN COMMISSION
Directorate General Internal Market and Services

FINANCIAL MARKETS
Financial markets infrastructure

Brussels, 16 October 2012

**LEGISLATION ON LEGAL CERTAINTY OF
SECURITIES HOLDING AND DISPOSITIONS**

Sixth Meeting of the Member States Working Group

10th Discussion Paper
of the Services of the Directorate-General Internal market and Services

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I INTRODUCTION

1. The last Member States Technical Expert Working Group took place last year on 23rd February, where it discussed the outcome of the 2nd public consultation. The principles consulted upon in this exercise followed the direction proposed by the Legal Certainty Group and the Geneva Securities Convention. They also incorporated the Working Group's efforts to develop draft legal rules¹. These initiatives were based on a legal perspective developed before the crisis in 2008.

2. Since the last meeting of the Working Group the Commission services have reassessed that approach for the following reasons:

- The request of the ECOFIN Council on 2 December 2008:

"- HIGHLIGHTS that the LCG's advice and the provisions of the draft UNIDROIT Convention on Intermediated Securities will also have to be closely scrutinised and evaluated in the light of the potential issues revealed by the recent developments of the financial crisis, recognising the need to avoid delays."

The Commission services have scrutinised the advice of the Working Group in the context of the failures of Bear Stearns, Lehman Brothers International Europe, and MF Global.

- Global regulatory initiatives support the move to collateral-based systems. However, there are several areas of potential weakness where this move may be undermined by certain features of "shadow banking," and some developments in the EU's financial markets driven by the international regulatory reform agenda.
- The Group's work needs to support and clarify the operations of CCPs as provided for in EMIR².

3. These important developments, and the Commission services' reassessment have highlighted fundamental issues that means that key areas of the Working Group's work on developing draft rules, and the last draft principles distributed to the Group, may require substantially different treatment if any proposed legislation is to be capable of providing viable solutions.

4. There needs to be a discussion on to develop a shared understanding of the evolving changes in the EU's financial markets, the main problems illustrated by repeated failures of collateral-based systems, an assessment of the causes, and the main potential policy options in response. While doing this, this discussion paper does not provide a revised set of possible rules. It takes the existing financial economic issues as its starting point and puts them in the context of the possible legal solutions that may be considered in the context of the forthcoming Securities Law Legislation (SLL). The outcome of the Working Group's discussion will therefore inform the Commission services and assist in making any necessary adaptations.

¹ Updated Compilation of the rules and explanatory notes discussed so far, 17/09/2010

² Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

II BACKGROUND AND WIDER PICTURE

5. It is important to first recall the key approaches informing regulators and market participants that are driving behaviour, the reforms to the system in reaction to the crisis, and the trends in the financial markets that are emerging in reaction to the reforms.

6. Generally, market participants want to own securities for one or more of three reasons: to invest in the hope of profitable returns; to receive them to use as collateral to protect against counterparty risk or to give them to secure funding; or to enjoy the rights that flow from them such as participating in corporate actions. The EU's financial market infrastructure needs to cater for all three.

7. Originally the holder of a money deposit was treated as having traceable property rights in individual coins. Over time, the nature of a depositor's rights has changed into a contractual claim against the bank. Nowadays, deposit banks are not required to have enough cash available to pay all customers.

8. Where securities are concerned, the standard has always been that a custodian has to hold sufficient securities in order to meet all its clients' claims. In most EU jurisdictions, such a standard is guaranteed by giving investors ownership rights towards securities.

9. Some markets, however, treat securities like money. The US and Canada based their law on the concept that investors do not own 'securities', but they own 'securities entitlements' against their account providers instead. The advantage of this concept is the potential increase in the amount of assets available as collateral, but critics view it as a threat to stability of the system, because the assets concerned are based on the same underlying resource.

10. This debate is central in the light of the agreed global regulatory response to the financial crisis. The decision to treat securities as property or claims has consequences for the development of our financial markets in the context of the decision of international regulators to make collateral the primary systemic risk mitigant (Basel III, central clearing of OTC derivatives etc.).

11. This decision rests on a critical assumption. According to regulators, collateral should be used to counteract counterparty risk. In the EU, collateral is mainly provided in the form of securities. However, an unforeseen consequence of the crisis has been the shrinking of the pool of high quality, liquid collateral.

12. This has had a direct impact on the behaviour of market participants. Concern has been voiced by market participants, regulators, central banks, and international institutions about potential collateral shortages, and increasing asset encumbrance. Not all securities are suitable for use as collateral and they are not evenly distributed. There is pressure to broaden the range of securities eligible as collateral. There are strong incentives for collateral mining, transformation, and transmission operations – core shadow banking activities.

13. As a result of the demand for collateral, securities are increasingly regarded by market participants as a funding tool. These trends reinforce the market trends to treat securities like money, creating complex inter-relationships (i.e. the shadow banking system) with significant implications for ownership. There is a clear division between the approaches on collateral as a prudential risk mitigant as opposed to a market funding tool.

14. These effects are particularly pronounced in the EU. Its financial system is heavily reliant on the wholesale markets for funding. Collateral is essential to securing this. Repo's and securities lending are key activities for the provision of liquidity and the survival of institutions in this collateral-based system. In this context cross-border legal uncertainty over "who owns what" complicated and contributed to the financial crisis and continues to do so today. It represents a fundamental obstacle to a safe and efficient Single Market for Financial Services.

Question 1: Have Member States' experts identified the same developing issues around collateral?

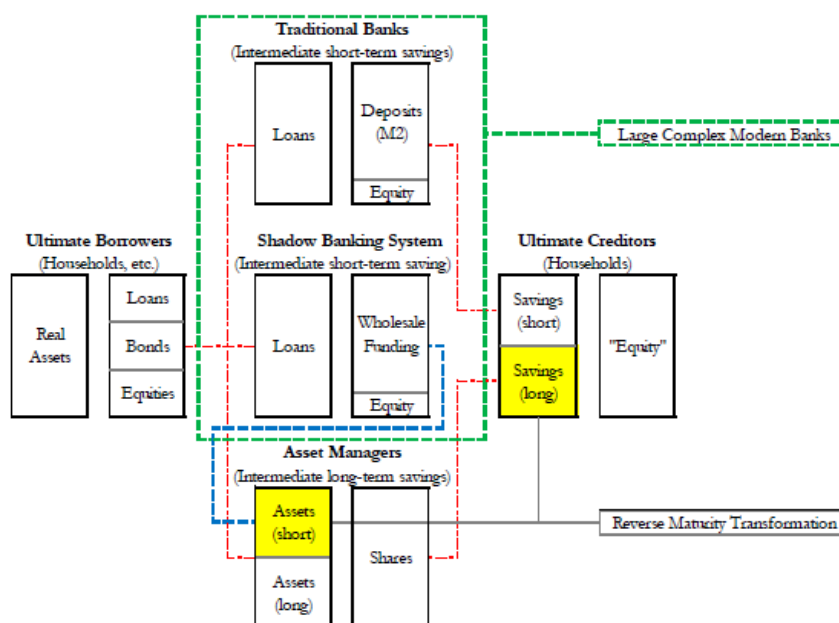
Question 2: Do Member States' experts consider that securities should be treated as 'property' and not as 'claims' akin to money?

III UNRESOLVED CHALLENGES OF COLLATERAL-BASED SYSTEMS

15. If the regulatory system is to rely on collateral-based systems to protect the EU financial sector against future financial crises, any weaknesses must be identified and addressed. The work on the SLL has an important role to play. This section examines practical examples that the SLL needs to take into account.

16. Funding operations based on collateral rehypothecation through repos, securities lending, prime brokerage, and money market funds are vital sources of liquidity that allow the markets to operate. But these sources add greater complexity and opacity. (See the diagram below³). The interconnections could act as channels of systemic risk. As a source of liquidity, they are vulnerable to instability.

Figure 2: A (more) Comprehensive Financial Intermediation Framework



³ Pg. 7, "The Nonbank-Bank Nexus and the Shadow Banking System," Z. Pozsar and M. Singh, IMF Working Paper WP/11/289, December 2011.

17. Previous SLL work has focused on the static holding chain between the issuer and the end investor. But consideration should also be given to the activities of buying, selling, and lending securities and who has the right to conduct these transactions. This suggests consideration of dynamic chains – a feature of "shadow banking." This recent and important issue of securities collateral has not been considered sufficiently. The IMF provides a useful explanation of "Shadow Banking" (see Annex 1 for an assessment of collateral chains).

18. At the heart of these problems are the concepts of "collateral re-use" and "rehypothecation." These terms are used interchangeably by market participants, and rehypothecation in particular can mean different things. This discussion paper is based on the following concepts:

- 'rehypothecation': any pre-default use of securities collateral (see Annex 2, definition 1);
- 're-use': pre-default use of securities collateral granted under a 'security interest collateral arrangement' (see Annex 2, definition 2);
- 'use': any use of client's securities that are held by an account provider and used by it to fund its own operations (see Annex 2, definition 3).

19. In response to the ECOFIN request and to the 2nd Public Consultation, the Commission services have also scrutinized the work of the Working Group in the context of the failures of Bear Stearns, Lehman Brothers International Europe, and MF Global.

Bear Stearns

20. The failure of Bear Stearns in March 2008 was a result of a combination of factors. Chief amongst these was the funding model based on sourcing collateral that it employed to support its highly leveraged operations. As a prime broker, it heavily relied on its ability to rehypothecate its clients' assets on the repo market to secure cash. The precipitous drop in liquidity illustrated by the chart below is a stark example of the instability of this funding when a crisis emerges. Unable to continue to fund itself, it collapsed.

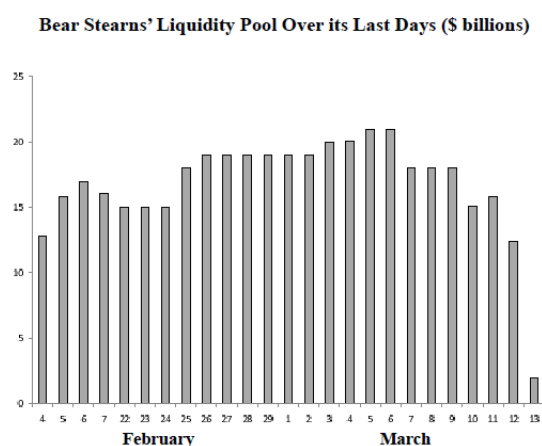


Figure 3.1: The sudden disappearance of cash at Bear Stearns in the days before it was acquired by J.P. Morgan in March 2008. Source: Testimony by SEC Chairman Chris Cox.

Source: Pg. 24, "How Big Banks Fail and What to Do about It," Darrel Duffie, 2011

21. Bear Stearns faced two major problems simultaneously. With its viability in doubt, many short-term creditors chose to avoid the hazards of selling the collateral they received, deciding to reinvest their cash in new repos with other counterparties. Others

chose to provide funding, but required much greater haircuts on the collateral. This had a critical impact because, as shown in the table below, Bear Stearns relied on repo-like transactions for 55% of its funding.

22. Concerned for the safety of their assets, Bear Stearns' clients started a run by moving their portfolios to other institutions. Without the ability to rehypothecate its clients' assets, Bear Stearns was unable to fund itself.

Table 3.1: Quarter-end financing of broker-dealer financial instruments before the failures of Bear Stearns and Lehman (dollars, in billions) Source: King (2008).

	May-08 Morgan Stanley	May-08 Goldman Sachs	May-08 Lehman	June-08 Merrill Lynch	Feb-08 Bear Stearns	2nd Qtr Total
Financial instruments owned	390	411	269	289	141	1,501
pledged (and can be repledged)	140	37	43	27	23	271
pledged (and cannot be repledged)	54	121	80	53	54	362
not pledged at all	196	253	146	208	64	868
Fraction pledged	50%	39%	46%	28%	55%	42%

Source: Pg. 31, "How Big Banks Fail and What to Do about It," Darrel Duffie, 2011

Lehman Brothers

23. The insolvency of Lehman Brothers in September 2008 confirmed that the conditions that caused the collapse of Bear Stearns are not unique, but are inherent to this funding model.

24. Lehman's bankruptcy caused two particular problems. *First*, its clients discovered that their assets were trapped in the insolvent estate, as the administrator had a duty to clearly identify the owners before returning the assets.

25. The Administrator encountered three major obstacles to returning these assets. Many of Lehman's clients held their assets in omnibus accounts. As a result, specific securities could not be identified against specific owners.

26. Most clients had also given Lehman the right to rehypothecate their securities. Many had attempted to revoke this right when it appeared that Lehman would fail. The Administrator was then faced with more claims to unrehypothecated securities than existed. This situation was complicated by the poor state of Lehman's book-keeping.

27. The insolvency procedure may last 20 years. Given that collateral is essential for securing funding, the longer investors are unable to access their securities, the higher the probability that they too will go bankrupt, raising the potential for chain reactions across the system.

28. *Second*, trust was undermined in client asset protection. Faced with the risk of their property, investors searched for safety in custodian banks and re-assessed who they gave rights of rehypothecation to. The chart below shows the impact this had on Morgan Stanley, which was reliant on repo-like transactions for 50% of its funding. The resulting liquidity crisis required significant intervention from Central Banks such as the NY Fed, Bank of England, and ECB.

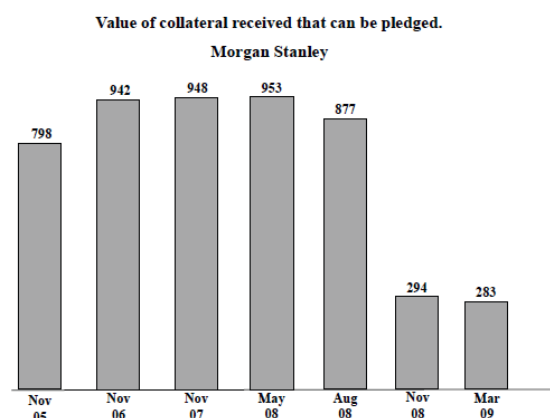
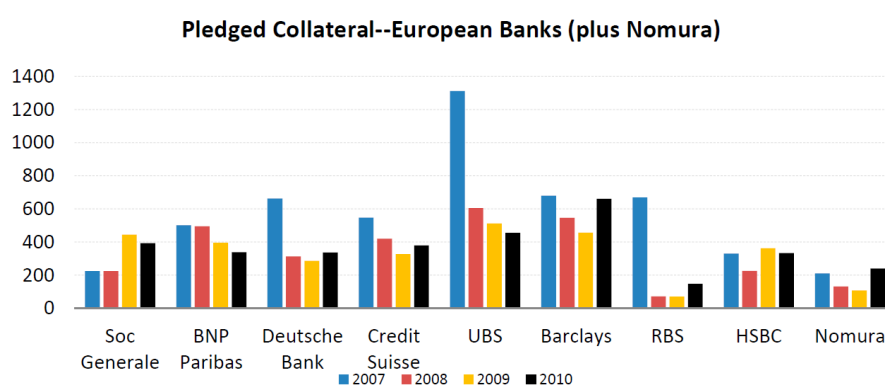


Figure 3.5: Assets pledged to Morgan Stanley that it was permitted to repledge dropped radically after the failure of Lehman. Data: SEC filings collected by Singh and Aitken (2009).

Source: Pg. 40, “How Big Banks Fail and What to Do about It,” Darrel Duffie, 2011



Source: Singh, Velocity of Pledged Collateral: Analysis and Implications, IMF Working Paper WP/11/256, November 2011

29. Although collateral is mainly provided using title transfer, data indicates that collateral provided using a security interest or pledge to European banks is also considerable. The IMF estimates that \$10 trillion of collateral was available globally in 2007. The chart above also illustrates the significant decrease in collateral provided using pledges in the aftermath of the collapse of Lehman Brothers. The result was that the collateral available globally dropped to \$5.8 trillion due to decreased rehypothecation, reduced repos/securities lending and collateral hoarding.

30. This drop in the availability of collateral has been identified as causing a deflationary shock as the system deleveraged. In short, rehypothecation can be an important source of liquidity but it is also capable of creating systemic instability.

31. However, despite this drop, the latest data illustrated in the chart below shows that collateral rehypothecation continues to provide a significant contribution to the balance sheets of systemically important financial institutions. This chart provides the clearest view of the current importance of these practices. It also demonstrates the limited overview available to regulators who do not have more transparency than this and are unable to identify concentrations of risk, exposures, and interconnections in the market.

Table 21: Re-hypothecated assets, FY2011, \$ bn

	Re-hypothecated assets	Adj Assets	Gross BS	As % of Adj Assets	As % of Gross BS
CS	364	832	1,845	44%	20%
UBS	436	787	1,320	55%	33%
GS	455	655	1,641	69%	28%
MS	335	572	1,772	59%	19%
DB	345	1,641	2,771	21%	12%
Barc	546	1,393	2,256	39%	24%
BoA	288	1,845	3,727	16%	8%
HSBC	189	2,129	2,476	9%	8%
Citi	350	1,658	2,634	21%	13%
Average				36%	18%

Source: Company reports and J.P. Morgan estimates. Adjusted assets are adjusted for repos and derivatives. Gross Balance sheet = adjusted assets+ gross derivatives. GS values also include collateral delivered

Source: J.P. Morgan CAZENOVE, Global Equity Research, 28 May 2012

MF Global

32. The third case the Commission services have examined concerns MF Global. The complementary nature of client asset protection and financial stability is further underlined by the latest developments in its insolvency. In April 2013, the High Court in London will decide whether US clients of MF Global have retained ownership in Treasury bills that MF Global transferred to the UK, which were then used as collateral in various Central Counterparties (CCPs).

33. The US Trustee advocates in its report⁴ that US clients should receive their securities back. The UK based CCPs contest this because such a judgement would undermine their risk model. This not only fits within the SLL where we have ever since aimed at providing for clear priority rules and ensuring good faith acquisition, but it has important ramifications for how EMIR will operate.

34. Many buy-side clients are concerned. For example, the Investment Management Association (IMA) has recently expressed similar concerns on transparency of ownership and protection of their assets.⁵

35. The way that collateral is provided from the buy-side to CCPs has already provoked potential innovation. For example, ICEClear in the UK intends to accept collateral provided by way of security interest in order to reassure participants over their concerns about ownership in the event of an insolvency.⁶ It is also worth noting that the process of providing the right collateral from the buy-side to CCPs may require intermediation and collateral transformation. This process appears to have strong similarities to prime-brokerage models.

36. In summary, and considering the ECOFIN request to evaluate the potential issues of the financial crisis, the problems that arose in the three cases described above and in order to address potential weaknesses in the collateral-based system, the Commission services believe that there may be a need to provide more harmonised solutions to issues such as transparency of ownership, account structures, reconciliation, rights of use, and methods of acquisition and disposition, for all market participants.

Question 3: Do Member States' experts agree with the analysis and implications set out above of the highlighted failures?

⁴ See Annex 3.

⁵ See Annex 3.

⁶ <http://www.ft.com/cms/s/0/e160e8b6-99e2-11e1-8fce-00144feabdc0.html#axzz25K4PnxEV>

Question 4: Do Member States' experts consider that the SLL needs to take account of the financial stability and client asset protection problems caused by the complexity and opacity of these funding models?

IV SLL: THE WIDER REGULATORY CONTEXT

37. As already briefly noted above, concerns about "shadow banking" are increasing. This section of the paper updates the Working Group on regulatory developments to address the market issues identified above. This section examines recent work in international fora that the SLL may need to take into account.

FSB Shadow Banking Workstream on securities lending and repo (Workstream 5)

38. The FSB defines shadow banking as 'the system of credit intermediation that involves entities and activities outside the regular banking system'. Banks and shadow banking entities are often exposed to common concentrations of risk through asset holdings. The FSB's Shadow Banking initiative and in particular its 'Workstream 5' focusing on securities lending and repo is of relevance to the SLL work.

39. On the basis of its market practices survey and regulatory mapping exercise, the interim report published in May⁷ identified seven issues for further investigation from a financial stability perspective. Of these, the most pertinent are "lack of transparency," the "procyclicality of system leverage/interconnectedness," "potential risks arising from agent lender practices," and "other potential financial stability issues associated with collateral re-use."

40. The FSB's work on rehypothecation is informed by its mandate to consider its potential systemic risks. The FSB currently defines rehypothecation as a specific instance of collateral re-use where a financial institution has a right of use over client assets. (This is treated as distinct from the 're-use' of collateral delivered by market counterparties to securities lending, repo or derivatives transactions).

41. Many participants consider that the rehypothecation of collateral where ownership clearly changes using 'title transfer' (transfer of ownership) should be excluded from the rehypothecation debate, due to concerns about the impact that inclusion could have on the liquidity of the markets. This issue is a fundamental driver for policy choices that need to be made.

42. The Workstream has developed a set of twelve recommendations that it proposes to submit in a report for public consultation after the meeting of the G20 Finance Ministers and Central Governors in November.

43. The most relevant recommendations centre on transparency of securities financing transactions, and client asset protection. As currently drafted they would give regulators clear sight of these activities so that they can identify exposures, concentrations, and interconnectedness. They would also restrict the ability of intermediaries to rehypothecate assets only with their clients' knowledge, and only for the purpose of supporting their clients' financing needs.

⁷ http://www.financialstabilityboard.org/publications/r_120427.pdf

FSB Client Asset Protection workstream

44. The FSB also recently set up a new workstream on client asset protection in order to identify possible impediments to the timely identification, recovery, transfer or return of holdings of clients assets that need to be addressed in order to give full effect to the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, adopted by the FSB in October 2011. This new workstream will look at rehypothecation from a client protection perspective and complement the FSB Shadow Banking work, which strictly focuses on financial stability issues only. It is expected to report back by the end of 2012.

European Commission Consultation on its Green Paper on Shadow Banking

45. The Commission published its Green Paper on Shadow Banking in March this year.⁸ It is currently analysing the responses it received during its consultation on the paper. Collateral rehypothecation is being considered from the perspective of the SLL.

ESRB recommendations on Shadow Banking

46. Following its response to the Commission's Green Paper,⁹ the ESRB has set up a workstream to assess shadow banking from a European perspective. It is currently developing recommendations on identification and monitoring of the shadow banking sector. We expect that these will be finalised and published by the end of 2012.

Basel Committee on Banking Supervision

47. A Consultative Document on margin requirements for non-centrally-cleared derivatives was issued in July 2012¹⁰. The public consultation was recently held until 28th September 2012. One of the proposed principles which has particular importance for the debate on rehypothecation is set out as follows (p. 25):

"Key principle

Because the exchange of initial margin on a net basis may be insufficient to protect two market participants with large, gross derivatives exposures to one another in the case of one of those firm's failure, the gross initial margin between such firms should be exchanged. Initial margin collected should be held in such a way as to ensure that

(i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and

(ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.

Jurisdictions are encouraged to review the relevant local laws to ensure that collateral can be sufficiently protected in the event of bankruptcy.

⁸ http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf

⁹ http://www.esrb.europa.eu/shared/pdf/2012-05-30_ESRB_reply.pdf?7205b70b00993d64891fcb032f1f1104

¹⁰ <http://www.bis.org/publ/bcbs226.htm>

Proposed requirement

Initial margin should be exchanged on a gross basis and held in a manner consistent with the key principle above. Cash and non-cash collateral collected as initial margin should not be re-hypothecated or re-used."

Question 5: Do Member States' experts agree that the SLL might need to address these Shadow Banking issues?

V SLL: CONSEQUENCES, KEY ISSUES, AND OPTIONS

48. Based on the analysis above, in order to address these challenges, the key problem appears to be that when the EU's fragmented operational and legal systems are combined with complex and opaque holding chains it is very difficult to identify "who owns what." Three key principles that could be considered in the development of a new policy response are:

- Alignment with the Geneva Securities Convention.
- Alignment with FSB's work on Shadow Banking.
- To improve financial stability, strengthen client asset protection, and enhance investor rights.

49. The focus on "who owns what" could represent a change of approach for the SLL proposal since the 2nd Public Consultation last year. Previous initiatives in this area such as the Legal Certainty Group and the Geneva Securities Convention have chosen to adopt a functional and neutral approach. This approach was considered to be appropriate prior to the financial crisis. However, in the light of the ECOFIN request, work in international fora and the analysis above, there may be a need to consider alternative solutions that are proportionate to the challenges that have been identified in this discussion paper.

50. Two particular challenges need to be contemplated. In addition to the issue of rehypothecation that has been identified above, the location of ownership also requires attention.

Question 6: Do Member States' experts consider that there is a need to address "who owns what" in response to the significant challenges that have been identified?

1. IDENTIFIED LEGAL PROBLEMS WITH REHYPOTHECATION

51. Three groups of problems involved with 'rehypothecation', 're-use' and 'use' can be identified that could be addressed by the SLL:

1. Collateral re-use chains.
2. No client protection if rehypothecation occurs;
3. Lack of transparency of rehypothecation and use of clients' assets;

Problem 1 – Collateral re-use chains

52. The allocation of risk to the client (and to the system) appears to be different depending on the legal method used for rehypothecation:

53. If the client transfers full ownership of the securities up front to its account provider (under a 'title transfer collateral arrangement'), the risk for the client is greater, since its assets are out of any client protection rules and it only retains the right to have equivalent securities returned. However, the rehypothecation chain as such does not carry any additional legal risk (see Annex 1). It is clear from the start that every collateral taker in the chain becomes the respective owner of the securities and can dispose of it (e.g. rehypothecate) as it wishes. In an insolvency scenario, the legal situation is clear.

54. However, a 'security interest collateral arrangement' is different, where the client continues, at first, to have a proprietary right and being subject to MiFID protection until the account provider chooses to exercise its 'right to use' the securities. However, at the point in time when the 'right of use' is exercised, the legal distinction between a title transfer and a security interest is blurred. Legal uncertainty arises as to whether the client's proprietary interests are wiped out or not. Moreover, re-use of security interest collateral carries greater risk to the financial system because multiple counterparties may compete for the same collateral in default (so called 'priority contests').

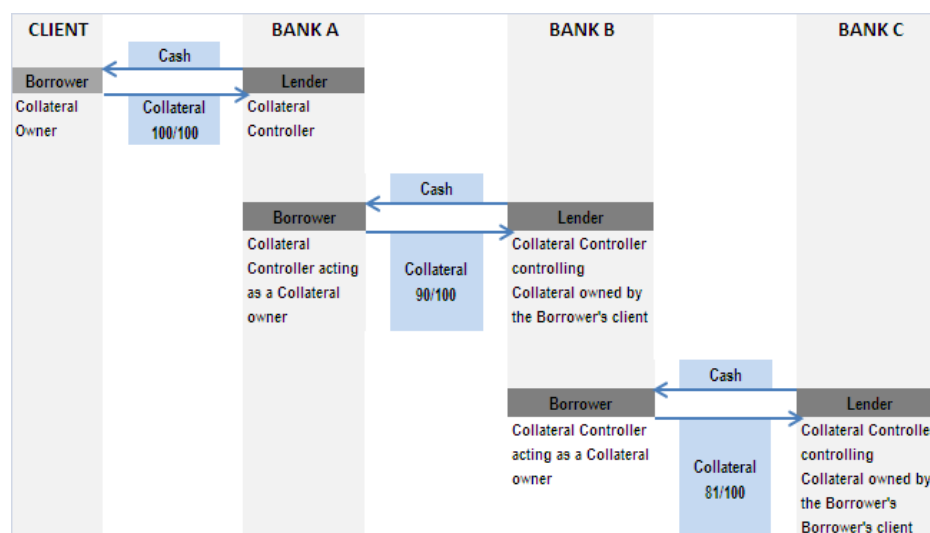


Figure 1: Collateral re-use chain (under security interest collateral arrangements)

Source: J.P.Morgan CAZENOVE, Global Equity Research, 28 May 2012, p. 20.

55. In the example above, the client is an owner of securities. It relies on bank A to provide finance, and as collateral it provides securities that it holds with bank A. The collateral is provided under a 'security interest collateral arrangement'. The parties agree that bank A is entitled to a 'right of use' of this collateral.

56. In order to secure its loan, bank A exercises its 'right of use' by providing its client's assets as collateral to bank B under a 'security interest collateral arrangement' combined with a 'right of use'. Subsequently, bank B exercises its 'right of use' and provides the securities as collateral to secure a transaction with bank C.

57. According to the Financial Collateral Directive (FCD), "*right of use' means the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement*".

58. A key question arises: who is the owner of those securities? If no debit/credit is required, the same securities are registered on different accounts with the risk of distorting the property law system. The following three scenarios arise:

59. Scenario 1: If bank A defaults, the client is left with a contractual claim towards bank A to have equivalent securities transferred. If the client is covered by the FCD, this contractual obligation may be subject of close-out netting allowing him to minimise its losses.

60. Scenario 2: However, if the client does not enjoy any close-out netting protection, does it, being the (original) owner of securities, have any proprietary claims to receive them back? Most commentators believe that in such a scenario the client is left only with a contractual claim towards bank A's insolvency estate. However, some case law goes in the opposite direction. In effect, the legal situation seems very unclear, in particular if the re-use chain crosses borders and different laws are applicable.

61. Scenario 3: If the client has not agreed to any 'right of use', but bank A disposes of the securities it holds for the client anyway. Competing proprietary claims between client A (owner), bank B (collateral taker of security interest) and bank C (collateral taker of security interest) arise.

62. In addition to the solutions already discussed at previous meetings¹¹, the Working Group could consider the following possible options:

63. **Amend the FCD and delete the possibility to grant a 'right of use'**. This option would remove legal uncertainties and re-establish the original distinction between 'title transfer' when the client loses ownership and 'security interest' when the client is not at risk of losing its ownership rights. The goal of liquid markets could be reached using the title transfer technique only.

64. **Supplement the FCD to expressly require a debit** in the client's account every time the 'right of use' under a 'security interest collateral arrangement' is exercised. This option honours the interests of all parties involved (the client realises that it loses his proprietary interest and the bank A's creditors are sure that their interests are enforceable).

Question 7: What are Member States experts' views on these options?

Problem 2: No client protection if rehypothecation occurs

65. Rehypothecation puts the client at risk: during the time the account provider exercises its rehypothecation right, the client's ownership right is replaced with a contractual right to return of equivalent securities. This contractual right is not protected by the current MiFID framework (MiFID protects only client's ownership rights).

66. This works well until a bankruptcy occurs. If the account provider defaults, a client with a mere contractual claim becomes an unsecured creditor, meaning the client's assets are, as a rule, tied in the insolvency estate and it is obliged to line up with all the other unsecured creditors to receive its assets back.

67. One could argue that from the client's perspective, the client's asset is no longer the securities it once owned so it is of little significance to the client to know where the particular securities are located and how the prime broker has chosen to use them.

¹¹ Article 9 (Protection of acquirers against reversal) and Article 10 (Priority) of Updated Compilation of the rules and explanatory notes discussed so far, 17/09/2010.

However, this argument appears to be questionable. Uncertainty as to whether the clients' securities will become subject to the claims of the prime broker's creditors to whom the securities have been rehypothecated can motivate clients to withdraw their holdings (see paragraph 22).

68. Despite these far reaching consequences, account providers in the EU may take any amount of clients' securities as collateral to cover any actual or even potential and future obligations the client might have towards them. In other words, no equivalence is required between the client's and the account provider's mutual obligations. Even if the client owes €1 to its account provider, the latter can propose in a prime brokerage agreement to take as collateral all client's assets that are safekept in the client's securities account, e.g. worth €1 billion, and, if the client agrees, to rehypothecate them.

69. The Working Group may discuss a number of potential solutions regarding the scope of the legal framework, the structure of accounts, reporting requirements, and caps or haircuts on the amount of securities that can be rehypothecated.

70. **Scope:** the SLL could establish a comprehensive legal framework *for all market participants that have a securities account*, irrespective of the rights they have towards those securities. This allows for the option to provide for client protection rules (explained in the next section) even if, legally speaking, the client has a mere contractual claim and is not the owner of the rehypothecated securities anymore. This would help investors to manage their exposure and make a more efficient use of their assets. Existing gaps in EU legislation could be closed.

71. One option could be to provide **cap on the amount of securities collateral that can be rehypothecated**. In the United States, broker-dealers can rehypothecate clients securities they hold as collateral up to 140% of the value of the client's net indebtedness, e.g. if a client has \$500 worth custody assets held with a broker and its net debt to the broker is \$200, the broker is able to rehypothecate $1.4 \times \$200 = \280 of the client's assets). There is a regulatory gap between the USA and the EU that leaves market participants the opportunity for arbitrage (when Lehman Brothers went bankrupt many US hedge funds found themselves with significant exposure to Lehman Brother International Europe as their prime brokerage agreements were structured to permit client-asset transfer to the prime brokerage's UK affiliate to circumvent the US cap). However, closing the loophole only in the EU might result in a migration of business to other jurisdictions.

72. **Obligation to offer a contractual 'rehypothecation cap'**: Alternatively, it could be considered to allow rehypothecation in respect of assets taken as collateral for the value of the client's actual obligation plus a reasonable haircut agreed by the parties. It may not directly align the EU framework with that of the US but it might give the parties the ability to negotiate a haircut equivalent to the 40% used in the US. The parties could not overrule these provisions by contract.

73. Finally, a **limit to the duration of rehypothecation**, (e.g. only for short-term transactions) could be considered so as to limit the exposure of investors.

Question 8: What are Member States experts' views on these options to increase client protection?

Problem 3- Lack of transparency of rehypothecation

74. As the Commissions second public consultation has indicated, there appears to be no uniform practice in the EU to debit the clients' accounts if rehypothecation happens. This can cause major problems. If account providers do not debit their clients' accounts when they use their clients' securities, several clients will have the same securities credited to their accounts at the same time. This hinders identification of 'who owns what' and creates hidden leverage allowing the entities involved to hide their existing debts.

75. The problem is exacerbated in the event of insolvency of an entity in the rehypothecation chain. Therefore, lack of transparency as to 'who owns what' threatens not only individual creditors, but the financial system as a whole. See the example below.

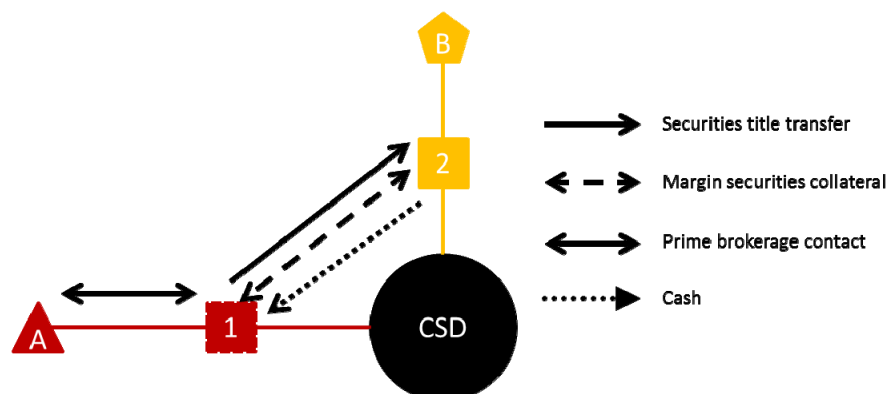


Figure 2: Rehypothecation of client's assets by a prime broker in a repo transaction

76. As part of the general terms of the prime brokerage agreements and in return for lower fees it would have to pay to the prime broker (worth 90-300 bps), client "A" gives its prime broker, "1," the right to rehypothecate its assets which are credited to "A"'s securities account. Although "A" should generally be aware of the legal risks under the agreement it enters into, it is not always aware of the extent of risks it faces, if it agrees to rehypothecation. "A" does not usually know if "1" exercises its right of rehypothecation, who "1" is transferring "A"'s securities to and how many of its assets have been rehypothecated.

77. "1" decides to exercise his right of rehypothecation over "A"'s securities as and when it wishes to use them, for example, in a derivative or a repo transaction with "2." The repo has the effect of moving "A"'s securities from the client account, to "2" in return for cash transferred to "1". Although "2" is now the full owner of the securities, "1" will not necessarily debit "A"'s account. In effect, the same securities are credited to two accounts during period from T until T+x.

78. However, if during this time prime broker "1" goes insolvent, as Lehman did, "A" will lose its securities and become an unsecured creditor to "1"'s estate for the amount of its rehypothecated securities. Because there was no debit to its account, "A" is unwittingly exposed to bankruptcy risk of "1".

79. A second problem area relates to the risk of unauthorised use of client's securities. Even if there is effective MiFID segregation (between the account provider's and its clients' assets), 'omnibus account structures' (where the securities of more clients are pooled), increase this risk, because the securities of one client can easily be used by the account provider to the benefit of another client, e.g. for settlement purposes (see example in Annex 2, point 16). On one hand, this practice greatly enhances settlement

efficiency, on the other, during this short term discrepancy clients are exposed to the custodian's insolvency risk without knowing it.

80. There are a number of potential solutions that could potentially be considered and some of them have already been discussed by the Working Group.

81. **Integrity of the issue:** *An account provider may only credit its client's account if it continuously holds a corresponding number of securities.* If account provider "1" credits securities to its client's "A"'s account, it will have to hold those securities by a specified method. If "1" uses "A"'s securities, it does not hold them anymore according to those methods. In effect, "1" is prevented from using "A"'s securities as long as the client's account remains credited. In other words, "A" can trust its "credit" and has always the express knowledge of its legal situation.

82. **Rights of use:** *Account providers could use the investors' securities only when they are transferred to them, or provided to them as collateral, in accordance with clear guidance. Account providers may use investors' securities in accordance with the agreement concluded with the investor.* If "A" agrees to rehypothecation, this contractual right has to be reflected in the account once it is exercised by "1". Depending on the legal method chosen, "A"'s account will either have to be debited or earmarked. In effect, "A" has always the express knowledge of its legal situation.

83. **Contractual transparency:** *Account providers could duly inform investors of the risks that may be involved in granting their consent to the use of their securities.* Client "A" is provided with more accessible information and transparency about the risks it takes when it consents to the rehypothecation of its securities.

84. **Reporting requirements:** *If requested by the client, an account provider that uses investor's securities could provide the client with a report of where and how those securities are being used.* Client "A" could manage its exposure to account provider "1" and make a more efficient use of its assets (e.g. ensuring that shares are not rehypothecated while "A" wants to exercise voting rights on them). Furthermore, changes in ownership may be required to be reported to a trade repository to give regulators oversight of market movements, concentrations, and exposures.

85. **Addressing Account Structures:** Finally, an option could be considered for securities holding structures building on what has been adopted in EMIR and is proposed in the CSD Regulation (see Annex 4). The investor could possibly be given the choice between a segregated and an omnibus account. If an investor chooses to hold securities in an individually segregated account, then it could be required that client securities are placed in segregated accounts at every level of the chain.

Question 9: What are Member States experts' views on these five possible solutions?

2. LOCATION OF OWNERSHIP RIGHTS

86. An objective of the SLL is to make "who owns what" clear. To do this, it has focused on promoting the book-entry in an account (the 'credit') as the definitive proof of rights. However, the main obstacle to this is the different concepts of ownership across the EU and the pooling of securities in omnibus accounts.

87. The two main account holding structures found in the holding chain that intermediates between issuers and investors are omnibus and individually segregated accounts. Omnibus accounts pool assets so that individual securities cannot be identified against specific owners. As a result, the holding chain is complex and opaque - especially in cross-border scenarios. The rights of account holders are unclear and may even be exercised more than once over the same security.

88. The number of account providers in the chain, who they are, or if the same account structure is employed throughout the chain, is unknown. Where the chain crosses borders, different laws apply to each individual relationship. Importantly, these laws can differ significantly about who is recognised as the owner of the securities and what rights account holders have to them, as illustrated by the diagram below.

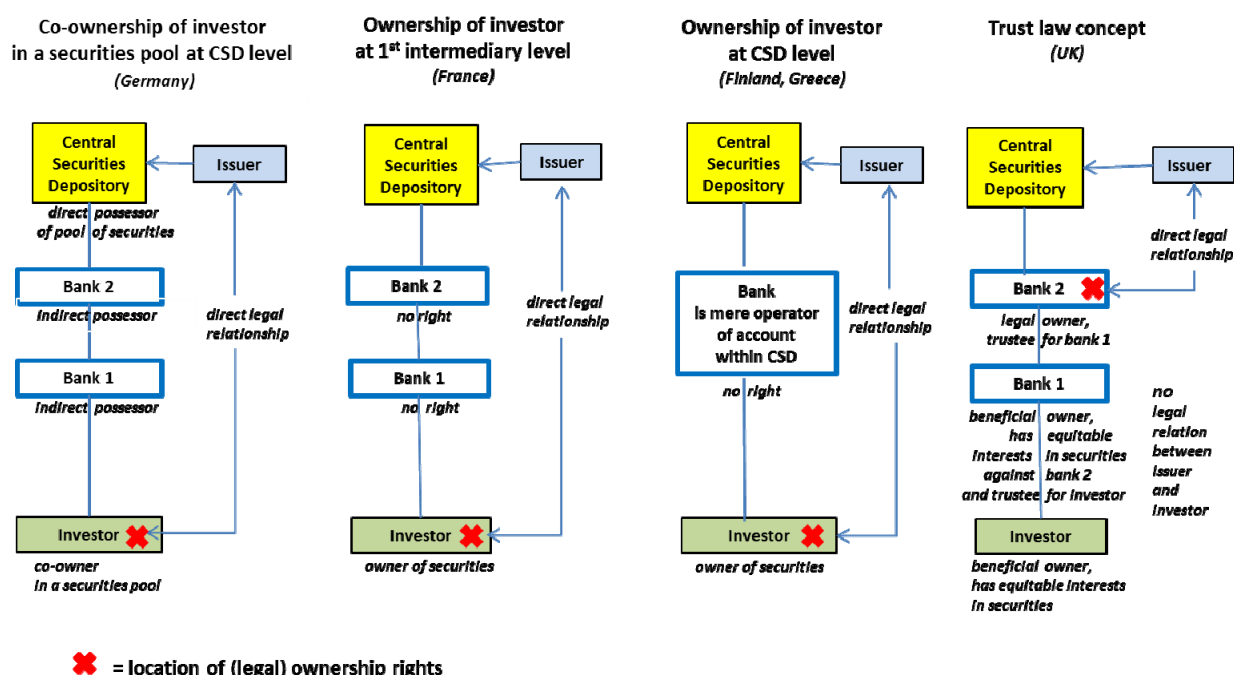


Figure 3: Some legal concepts underpinning intermediated securities holdings

89. While each solution works well domestically, a combination of them in one holding chain can cause significant legal problems when the holding chain crosses borders in the EU (see Annex 5). One consistent feature of the Working Group's approach has been to promote the book-entry in an account as representing rights of the account holder. But which account containing the credit should be considered as the definitive proof of legal ownership?

Question 10: Do Member States' experts consider that a conflict-of-law solution may be capable of answering the question 'who owns what' uniformly throughout the EU?

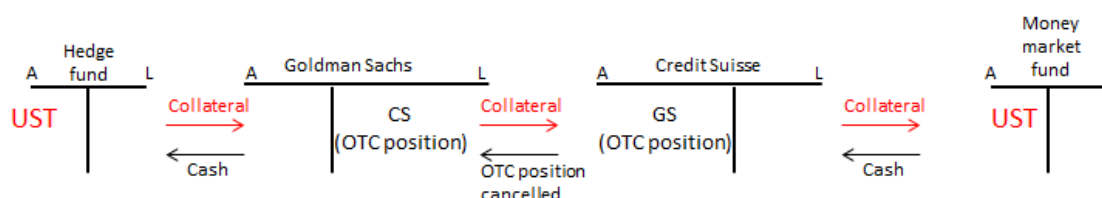
Question 11: What are Member States experts' views on harmonising the concept of ownership for account-held securities across Europe so that there is only one owner?

Annex 1

Economic assessment of dynamic chains

The figure below illustrates how a piece of collateral (e.g., US Treasury bond) may be used by a hedge fund to get financing from a prime-broker (say, Goldman Sachs). The same collateral may be used by Goldman to pay Credit Suisse on an OTC derivative position where Goldman was 'out-of-the-money' to Credit Suisse. And then Credit Suisse may finally pass the US Treasury bond to a money market fund that will hold it for a short tenor (or till maturity). Notice that the same Treasury bond has been used twice three times as collateral for extensions of credit – from the original hedge-fund owner to the money market fund.

An example of a dynamic collateral chain



Source: <http://www.voxeu.org/article/other-deleveraging-what-economists-need-know-about-modern-money-creation-process>

Legal assessment of dynamic chains

1. **If all the subsequent deals in the chain are collateralised and protected by the FCD**, then if broker-dealer 1 rehypothecates collateral received from the hedge fund with broker-dealer 2, the rehypothecated asset is only given in exchange for an equivalent value.
2. If the same is true for the rest of the chain, there appears to be little contagion effect in the rehypothecation chain. If a rehypothecating collateral taker (e.g. broker-dealer 2) defaults, its counterparty (broker-dealer 1) can close out its transactions, immediately enforce collateral and discharge its obligation towards the preceding link. In this scenario, the only remaining risk each party effectively faces is a market risk that the value of collateral securities provided in the transaction is not sufficient to cover the obligation.
3. The level of protection given to securities collateral and close-out netting is harmonised in the EU by the FCD. Upon the collateral taker's default, the FCD gives certain collateral providers the right to enforce their contractual close-out netting provisions and immediately enforce securities collateral.

When a party closes-out transactions and invokes netting against a counterparty, it essentially fulfils an obligation towards that counterparty even if no actual, physical payments take place. At the same time, it receives payment in respect of a claim, which it has against that counterparty (up to the amount of the lesser obligation). In insolvency, this means that a client who is in the position to invoke close-out netting is in a better position than other creditors who do not have this option.

However, the personal scope of the FCD is restricted and covers only public authorities, central banks, the ECB, BIS, IMF, EIB, credit institutions, investment firms, insurance undertakings, UCITS, CCPs and leaves it up for Member States to decide whether they want to apply the FCD rules to situations where the financial institution's counterparty is "a person other than a natural person".

4. By way of contrast, **if not all transactions in the chain have been secured with collateral and not all participants can rely on its immediate enforcement and close out netting rights, the rehypothecation chain appears to pose a contagion risk.**

5. If no equivalent collateral is provided or not all links in the chain are subject to close-out netting protection (e.g. the FCD, as it stands now, does not protect hedge funds or individual investors), those market participants that cannot close-out transactions and enforce collateral immediately are more vulnerable to bankruptcy of their counterparties. If broker-dealer 2 defaults and broker-dealer 1 cannot close out and immediately enforce collateral, it might not be able to discharge its obligation towards the hedge fund and go bankrupt.

6. The longer the assets are trapped in the insolvency estate (the bankruptcy procedure can take several years), the higher the risk of a domino effect. This would possibly support extending the scope of the FCD. However, caution may be wise with any extension of the scope, since it would inevitably be at the expense of other creditors and might create moral hazard.

Annex 2

Definitions of Rehypotheccation

1. Defining the practice of rehypotheccation is complex. A key problem with understanding and therefore regulating rehypotheccation is that the term means different things to different people. For example, the FSB Workstream on repos and securities lending defines re-hypotheccation as a specific instance of collateral re-use where a financial institution has a right of use over client assets. For the workstream, this is distinct from the re-use of collateral delivered by market counterparties to securities lending, repo or derivatives transactions.
2. From a legal perspective, three ways of looking at rehypotheccation can be distinguished:
 - 1) Any pre-default use of securities collateral;
 - 2) Pre-default re-use of securities collateral granted under a 'security interest collateral arrangement';
 - 3) Any use of client's securities that are held by an account provider and used by it to fund its own operations.

Definition 1: Any pre-default use of collateral

3. The term 'rehypotheccation' is often used to describe any pre-default use of financial collateral by the collateral taker for its own purposes, whether provided under a security interest or a title transfer collateral arrangement. To fully understand this definition, one has to answer an initial question: what is the purpose of collateral?
4. The primary purpose of collateral is to protect B (collateral taker) against the credit risk exposure that B takes on from A (collateral giver) as a result of a financial transaction. If in a transaction between A and B (e.g. a derivative transaction or a loan), A owes money to B, and B wants to ensure that it gets paid, B would want to acquire a proprietary interest in an agreed amount of A's assets (the collateral). As a result, if A defaults, B has a right to liquidate the collateral and satisfy its claim out of the value of those assets.
5. The FCD prescribes two ways of granting collateral:
 - by title transfer - B takes an absolute interest in the financial asset that is achieved by transfer of ownership from A, or
 - by granting a security interest - A grants a pledge to B over its asset.
6. If A defaults, the FCD gives B the right of immediate enforcement, i.e. to immediately liquidate the collateral (sell it) to satisfy its claim. However, if A does not default and duly satisfies B's claim in the transaction, B is obliged to return the equivalent collateral back to A.
7. In this context, 'rehypotheccation' means that before A's potential default, B uses the collateral provided by A, under a security interest or a title transfer arrangement, as its own for any purpose whatsoever (e.g. lends or sells it or uses it as its own collateral). Therefore, rehypotheccation allows collateral to be used as a tool to generate revenue if it is not dedicated as insurance against A's potential default. This in practice provides additional liquidity to the markets.

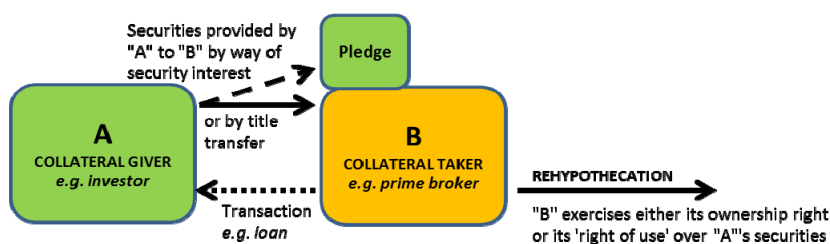


Figure 1 – Rehypothecation according to the first definition

Definition 2: Pre-default re-use of securities collateral granted under a 'security interest collateral arrangement'

8. The understanding of 'rehypothecation' can also be restricted to mean only the pre-default right of use of financial collateral granted under a security interest collateral agreement. This understanding stems from Article 5 of the FCD, which introduced the 'right of use' of collateral granted by way of security interest to the EU.

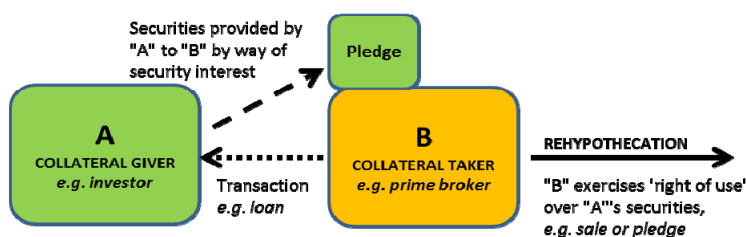


Figure 2 – Rehypothecation according to the second definition

9. When the collateral is granted by way of security interest such as pledge, the ownership of the collateralised asset remains with the collateral giver, A, and the collateral taker, B, only obtains a pledge on the asset. In such a scenario, the FCD allows the parties to contractually agree on a 'right of use' of the pledged collateral. As a result, the collateral taker, B, obtains the right to transfer ownership of the pledged collateral to a third party or to re-pledge the pledged collateral for the benefit of a third party, thus using the pledged collateral for its own business purposes. At the end of the transaction (and in the absence of default), the collateral taker, B, has an obligation to deliver equivalent assets to the collateral provider, A.

10. The restriction of 'rehypothecation' to the Article 5 of the FCD scenario is more precise, because the use of collateral granted under a title transfer is not, strictly speaking, a "re-hypothecation" since the collateral taker becomes at the same time the collateral owner for the duration of the transaction. As such he has a right to do what he likes with it (lend, sell, or otherwise dispose of it.). Therefore, legally speaking, B does not re-hypothecate anything, but only exercises its own ownership rights.

11. However, one should be careful in restricting the meaning of 'rehypothecation' to the 'right of use' only. Master Agreements employed in the EU markets predominantly base rehypothecation on the title transfer method of providing collateral¹². This stems

¹² The title transfer method, for example, is used in the Global Master Repurchase Agreement (GMRA) of repos, the Global Master Securities Lending Agreement (GMSLA) for securities lending and, if English law applies, the ISDA Margin Provisions for derivatives.

from the practice of including in standard prime brokerage agreements the wording of recital 27 of MiFID which allows investment firms to obtain title transfer of client's assets to cover 'any actual or potential, present or future or contingent obligations a client might have towards it'¹³.

12. In effect, an investment firm may book the securities as its own on its records and they are not covered by the MiFID client asset protection rules (e.g. rules that impose segregation between the client's and the firm's assets and require that the investment firm uses securities only with the client's express consent).

13. It is important to note that in the on-going MiFID review the Commission proposed to address this problem by banning title transfer collateral arrangements with retail clients for the purpose of securing or covering clients' present or future, actual or contingent or prospective obligation¹⁴. This effectively prevents rehypothecation of retail clients' assets.

Definition 3: Any use of client's securities that are held by the account provider and used by it to fund its own operations

14. In its broadest sense, rehypothecation is sometimes equated with any use of client's securities, and not only those assets which were given as collateral to the rehypothecating party. This notion includes, for example, the unauthorised use of clients' securities by its custodian or any other upper-tier account provider.

15. The risk of unauthorised use of clients' assets is increased by the employment of omnibus account structures. Omnibus accounts pool assets so that individual securities cannot be identified against specific investors. The CPSS IOSCO principles, MiFID Implementing Directive and AIMFD require only partial segregation. This is achieved where the securities of a client are segregated from the account provider's securities, but the client's securities are co-mingled with the other clients' assets.

16. In such a scenario the securities of client A can easily be used by the account provider to the benefit of another client B (e.g. if a custodian holds 100 securities in an omnibus account with a CSD for two clients, both owing 50 securities, and client A sells 60 securities because he is supposed to receive 10 securities he has bought in the meantime, but which are not yet credited to his account because T+2, then the CSD debits 60 securities from the custodian's omnibus account). On one hand, this practice greatly enhances settlement efficiency, on the other, during this short term discrepancy clients are exposed to the account provider's bankruptcy risk without often knowing it.

¹³ According to MiFID recital 27 "Where a client, in line with Community legislation and in particular Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, transfers full ownership of financial instruments or funds to an investment firm for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations, such financial instrument or funds should likewise no longer be regarded as belonging to the client".

¹⁴ According to Article 16(10) MiFID recast, COM(2011) 656 final: "An investment firm shall not conclude title transfer collateral arrangements with retail clients for the purpose of securing or covering clients' present or future, actual or contingent or prospective obligations".

Annex 3

The relevant sections of the MF Global Trustee Report

p. 156-160: *The Joint Special Administrators’ apparent position rests on an important distinction between U.S. and English law concerning the protection of customer property. Under U.S. law, all customer property held by a U.S. FCM is protected by statute and cannot be used to satisfy general creditor claims in the event of the FCM’s insolvency. Under English law, while money and other assets belonging to a client but held by an FSA-authorized investment firm must generally be segregated by the FSA-authorized investment firm under CASS 7 and CASS 6 and protected from distribution to general creditors in the event of the firm’s insolvency, certain types of clients can agree to alternative arrangements which potentially afford lesser protection in the event of insolvency. Specifically, certain customers may consent to absolute title transfer of that customer’s assets to the FSA-authorized investment firm under a “title transfer collateral arrangement”, pursuant to recital 27 of the European Markets in Financial Instruments Directive (“MiFID”) as implemented by the FSA’s CASS 6.1.6 R and CASS 7.2.3 R. Such arrangements apply where an appropriate client of a firm transfers full ownership of an asset (including money) to a firm for the purpose of securing or otherwise covering present or future, actual, contingent, or prospective obligations. In the event of such absolute title transfer, the relevant assets cease to be client assets upon such transfer and, accordingly, do not receive protections required under either CASS 7 or CASS 6. In general, in the event of the firm’s insolvency, the customer would generally rank only as a general unsecured creditor in relation to those assets.*

p. 172-175: XIV. Recommendations

B. Eliminate The Segregated vs. Secured Distinction Currently Made By Regulation 30.7, Ensure Consistency of Customer Protection When Trading Overseas, And Closely Monitor Compliance Abroad

Customer funds and other property, whether kept in individual accounts or in omnibus accounts, should always be treated as segregated funds. Currently, few regulatory regimes globally provide specific rules to govern the treatment of customer omnibus accounts and those that do so, do so sparingly at best. It is critical that global exchanges recognize both the concept of a customer omnibus account and create coding on their operational systems to identify such accounts, as well as to distinguish customer omnibus accounts from firm proprietary accounts. So identified, customer omnibus accounts should either be (i) allowed to be easily transferred to another firm upon insolvency of the FCM or (ii) promptly liquidated and the proceeds returned to the FCM.

U.S. and foreign insolvency rules should be amended to clarify that customer omnibus accounts should not be subject to offsets, other than for debts directly related to those accounts. In this case, the Canadian Trustee has interpreted the applicable Canadian law to require offset of amounts owing to MFG Canada on its customer omnibus accounts held by MFGI against the larger amount owed to MFGI on its customer omnibus accounts held by MFG Canada. Although the amounts are not material in MFGI’s case, this type of offset approach could result in preferential treatment for customers in one jurisdiction as opposed to another in contradiction to the expectations of customers and regulators. Regardless of the legal status of a customer omnibus account, the funds held in that account ultimately belong to the many underlying customers of the financial services firm.

Differences between U.S. rules and insolvency rules and financial services regulations in other jurisdictions that give rise to arguments as to the proper status of customer protection, leading to the disputes such as the pending litigation with the Joint Special Administrators of MFGUK, should be eliminated. All property held in a customer omnibus account should be required to be segregated in a manner similar to U.S. law and receive the maximum protection afforded under local law. A country should not be considered a good secured location for customer funds pursuant to applicable regulations where that country's regulations fail to provide for specific rules requiring segregation of all customer property, including such property held in customer omnibus accounts.

Key extract from the IMA's response to ESMA's consultation paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories," published on 3rd August 2012.

EMIR helpfully brought in both individual client segregation and omnibus client segregation, requiring clearing houses to offer choice in both. Omnibus client segregation is used now in clearing for listed derivatives and, with pre-specified fungible contracts traded on exchange, can work well. In the much larger OTC derivatives market the proper introduction of individual client segregation is critical.

The practical effect of individual client segregation is likely to be the introduction of gross margining into the market. If gross margining becomes the norm for individual client segregated accounts, it becomes questionable whether the use of a principal to principal legal structure should be sustained, or be the only model used. An agency model would by contrast recognise that the principals are the CCP and the client, and the role of other parties pertained to the carrying out of the transaction but not to legal ownership of the positions, assets and money.

The concept of individual client segregation is closely connected to the concept of being able to port trades in the event of a clearing member default. A key difficulty in the principal market model is that for a CCP to be able to port client positions, assets and money, it must know the identity of the client in advance, know, exactly all the positions, assets and money attributable to that client and be entirely clear on ownership and other relevant property rights in relation to the assets and money. The use of title transfer as the preferred mechanism for posting collateral to meet margin requirements sits uneasily with the concept of individual client segregation and the porting obligations.

We therefore ask ESMA to:

Make any changes necessary to the Technical Standards to ensure that there are no barriers to clearing using an agency model; and

Encourage the market and competent authorities to support the introduction of an agency model for clearing OTC derivatives, by rigorous scrutiny of the degree of investor protection offered by CCPs in relation to segregation of clients' assets, money and positions, and their ability to carry out porting.

Annex 4
Segregation in EMIR and CSDR proposal

**Regulation (EU) No 648/2012 of the European Parliament and of the Council
of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
(EMIR)**

Article 39

Segregation and portability

1. A CCP shall keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets.
2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients (‘omnibus client segregation’).
3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients (‘individual client segregation’). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients.
4. A clearing member shall keep separate records and accounts that enable it to distinguish both in accounts held with the CCP and in its own accounts its assets and positions from the assets and positions held for the account of its clients at the CCP.
5. A clearing member shall offer its clients, at least, the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection referred to in paragraph 7 associated with each option. The client shall confirm its choice in writing.
6. When a client opts for individual client segregation, any margin in excess of the client’s requirement shall also be posted to the CCP and distinguished from the margins of other clients or clearing members and shall not be exposed to losses connected to positions recorded in another account.
7. CCPs and clearing members shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation shall include a description of the main legal implications of the respective levels of segregation offered including information on the insolvency law applicable in the relevant jurisdictions.
8. A CCP shall have a right of use relating to the margins or default fund contributions collected via a security financial collateral arrangement, within the meaning of Article 2(1)(c) of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements provided that the use of such arrangements is provided for in its operating rules. The clearing member shall confirm its acceptance of

the operating rules in writing. The CCP shall publicly disclose that right of use, which shall be exercised in accordance with Article 47.

9. The requirement to distinguish assets and positions with the CCP in accounts is satisfied where:

- (a) the assets and positions are recorded in separate accounts;
- (b) the netting of positions recorded on different accounts is prevented;
- (c) the assets covering the positions recorded in an account are not exposed to losses connected to positions recorded in another account.

10. Assets refer to collateral held to cover positions and include the right to the transfer of assets equivalent to that collateral or the proceeds of the realisation of any collateral, but does not include default fund contributions.

Proposal for a Regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC (CSDR proposal), COM(2012)73 final

Article 35

Protection of participants' securities

- 1. For each securities settlement system it operates a CSD shall keep records and accounts that shall enable it, at any time and without delay, to distinguish in the accounts with the CSD the securities of a participant from the securities of any other participant and, if applicable, from the CSD's own assets.
- 2. A CSD shall keep records and accounts that enable a participant to distinguish the securities of that participant from those of that participant's clients.
- 3. A CSD shall offer to keep records and accounts enabling a participant to distinguish the securities of each of that participant's clients, if and as required by that participant ('individual client segregation').
- 4. A CSD shall publicly disclose the level of protection and the costs associated with the different levels of segregation it provides and shall offer these services under reasonable commercial terms.
- 5. A CSD shall not use the securities of a participant for any purpose unless it has obtained that participant's express consent.
- 6. ESMA shall develop in consultation with the members of the ESCB draft regulatory technical standards specifying the book-entry methods and the account structures enabling the distinction between the holdings referred under paragraphs 1 to 3 and the methods of assessment thereof.

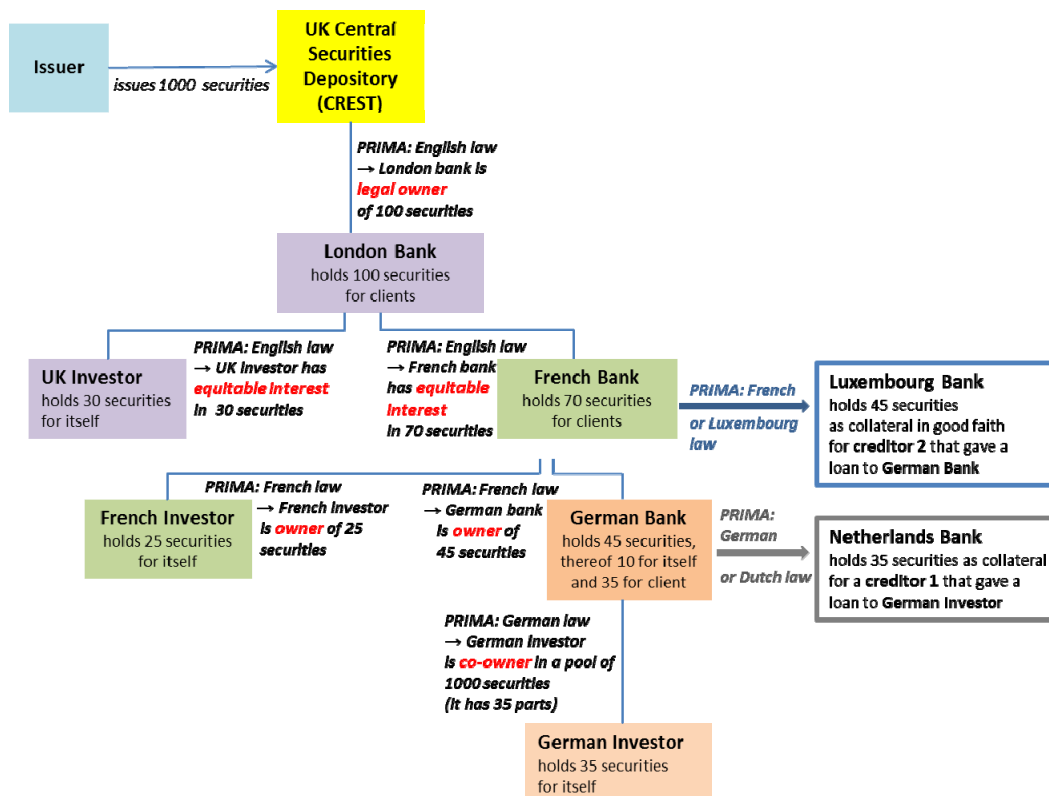
ESMA shall submit those draft regulatory technical standards to the Commission by six months from the date of entry into force of this Regulation.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1095/2010.

Annex 5

Conflicts of laws

1. Under the assumption that the law applicable is established independently with respect to each securities account, and the “Place of the Relevant Intermediary Approach” (PRIMA) is employed¹⁵, there is no single law that would govern all proprietary issues with respect to all securities accounts maintained by account providers standing between the investor and the issuer.



¹⁵ **Article 9 FCD: Conflict of laws**

1. Any question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral shall be governed by **the law of the country in which the relevant account is maintained**. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country.

2. The matters referred to in paragraph 1 are:

- (a) the legal nature and proprietary effects of book entry securities collateral;
- (b) the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and the provision of book entry securities collateral under such an arrangement, and more generally the completion of the steps necessary to render such an arrangement and provision effective against third parties;
- (c) whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest, or a good faith acquisition has occurred;
- (d) the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

2. Particularly, in case of unclear or even fraudulent acting of the disposing account holder, priority contests can easily arise and no single law can be identified to solve them, as demonstrated by the example illustrated above:
3. The German Investor holds 35 securities in an account maintained by the German Bank. The investor needs cash and provides its 35 securities to creditor 1 as collateral in order to obtain credit.
4. The provision of collateral can be performed in two ways. Firstly, by way of 'security interest' where the German Investor's account at the German Bank is earmarked in favour of creditor 1. In consequence, the relevant account is with the German Bank and according to Article 2(1)h FCD¹⁶ and PRIMA, German law applies to assess whether creditor 1 has obtained a valid interest.
5. Secondly, collateral can be given by way of 'title transfer', in which case the ownership of the securities is transferred from the German Investor's account to the creditor 1's account maintained by the Netherlands Bank. In this second scenario, it is Netherlands' law that governs all proprietary issues which might arise in respect of the 35 securities.
6. It is assumed that, in the first scenario (earmarking) the German Bank is on the brink of insolvency and also needs cash. It disregards the preceding earmarking in favour of creditor 1 and provides all 45 securities as collateral to its own creditor 2 by instructing the French Bank to either:
 - a. earmark them in favour of creditor 2 (under French law) or
 - b. to transfer the securities to the Luxembourg Bank who now holds them for creditor 2 (under Luxembourg law).
7. Shortly thereafter, the German Bank becomes insolvent and the question arises who is the owner of the securities. Has creditor 2 acquired all 45 securities because it was in good faith? Or does creditor 1 win the priority contest because it acquired validly its 35 securities first in time?
8. Which law gives answer to these questions as there are at least two laws applicable: German law (the law of earmarking in favour of creditor 1) and French (the law of earmarking in favour of creditor 2) or Luxembourg law (the law of credit in favour of creditor 2), depending on the method of collateral provision to creditor 2?

¹⁶ **Article 2(1)h FCD:** "**'relevant account'** means in relation to book entry securities collateral which is subject to a financial collateral arrangement, the register or **account** — which may be maintained by the collateral taker — **in which the entries are made by which that book entry securities collateral is provided to the collateral taker**"

Recital 8 FCD: *The lex rei sitae rule, according to which the applicable law for determining whether a financial collateral arrangement is properly perfected and therefore good against third parties is the law of the country where the financial collateral is located, is currently recognised by all Member States. Without affecting the application of this Directive to directly-held securities, the location of book entry securities provided as financial collateral and held through one or more intermediaries should be determined.*

If the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation.